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The global economy

The turning point

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Illustration by James Fryer

Does the latest financial crisis signal the end of a golden age of stable growth?

IF ECONOMICS were a children's tale, a long period of rising incomes and improving living standards would always be followed by a big, bad recession. Rising unemployment, falling spending and contracting output—such is the inevitable reckoning for the good times of plentiful jobs and abundant earnings that went before. The hangover needs to be commensurate with the party.

No country has had it quite so good as America. For the past 20 years or more its economy has managed an enviable combination of steady growth and low inflation. To add to its good fortune, spending has routinely exceeded its income—leading to a persistent current-account deficit—without any apparent ill effects on the economy. The occasional setbacks have been remarkably small by historical standards. At the start of 1991, for instance, America's GDP fell for a second successive quarter (a common definition of a recession). But output soon recovered and by the end of the year had surpassed its previous peak. The next downturn, in 2001, was shallower still, with GDP dipping by less than half a percent.

More recently, other rich countries have enjoyed a similar improvement in economic stability. The ups and downs of economic life, known as the business cycle, have provided a much smoother ride than they once did. That is partly why there has been such a clamour for financial and housing assets, and why firms and households have been more willing to take on debt. A lot is now riding on this golden age of stability continuing.

But perceptions about risk are shifting. America's economy, for so long seemingly impregnable, has been growing rather meekly for the past year, weighed down by a slump in housebuilding. The ongoing crisis in credit markets threatens it with recession. Some observers, long mystified by America's ability to live beyond its means and postpone what they see as an unavoidable downturn, think that the world's biggest economy might finally have run out of luck.

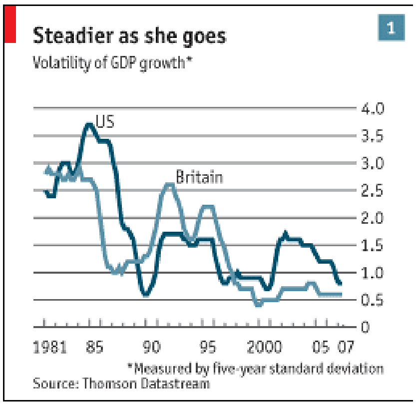
Competing views about what lies ahead are themselves cyclical. When growth is steady, the belief that the business cycle can be tamed is understandably high. When recession threatens, that confidence can quickly vanish. On a pessimistic view the "Great Moderation"—the sharp drop in economic instability in America and other rich countries—will prove illusory. But an optimist would counter that the vast improvement in economic stability has been so marked that it will not just disappear overnight.

The world economy has reached a decisive point. If that magical combination of growth and stability was just luck, it is now due a long-postponed and painful correction. But if it was thanks to changes in the way the world works, does that mean the golden age will endure?

Luck or judgment?

Much of the focus—in good times past, as well as bad times present—has been on America, where fluctuations in economic growth have fallen by around half since the early 1980s (see chart 1). In upswings the economy's growth rate has varied by less from one quarter of the year to the next and from year to year. Recessions have been rarer, shorter and shallower.

The most visible symptom of this smoother trajectory is in the jobs market. Since the mid-1980s, America's unemployment rate has fluctuated far less than it did in earlier generations. Between 1961 and 1983, America's annual unemployment rate varied from 3.5% to 9.7%. Since 1984, it has stayed within the tighter bounds of 4% to 7.5%.



Much of America's good fortune has been repeated elsewhere. A study published last year by Stephen Cecchetti, of Brandeis University, Alfonso Flores-Lagunes, of the University of Arizona, and Stefan Krause, of Emory University, found that 16 out of 25 OECD economies, including Britain, Germany, Spain and Australia, had also seen a marked improvement in economic stability.

What lay behind that change? The sceptical view is that improved stability has no cause: it is mostly down to luck. Economic shocks—abrupt shifts in business conditions—have by chance been less powerful. The economy is no better at taking a hit; it is just that since the two oil-supply shocks of the 1970s the punches have not been so hard.

Yet the global economy has taken some big blows during the golden age. In the last decade the rich world has weathered the Asian financial crisis, Russia's debt default, the dotcom boom and bust, terrorist attacks on America, sharp increases in oil prices and the uncertainty that came with wars in Afghanistan and Iraq. Still, economic volatility has not picked up. It is true that the abrupt curtailment of energy supplies to a world that was highly dependent on oil was a unique and traumatic event. But economies were more hidebound then: job markets were less flexible and producers more stymied by regulation. The painful results cannot wholly be put down to energy dependency.

The flexible economy

The more likely explanation is that economies have become far better at absorbing shocks, because they are more flexible. There are many structural shifts that might have contributed to this, from globalisation to the decline of manufacturing in the rich world. The academic literature keeps returning to three: improvements in managing stocks of goods, the financial innovation that expanded credit markets, and wiser monetary policy.

For such a tiny part of GDP, the content of warehouses has had a surprisingly big effect on its volatility. When industries cut or add stocks according to demand, that adjustment magnifies the effect of the initial change in sales. Stock levels were once much larger relative to the size of the economy, so a small slip in demand could easily blow up into a recession. But thanks to improvements in technology, firms now have timelier and better information about buyers. Speedier market intelligence and production in smaller batches allows firms to match supply to changing conditions. This makes huge stocks unnecessary and minimises the lurches in inventories that were once so destabilising. The entire inventory of some lean-running companies now consists of whatever FedEx or UPS is shipping on their account.

Mr Cecchetti and his colleagues calculate that, on average, more than half the improvement in the stability of economic growth in the countries they studied is accounted for by diminished inventory cycles. That something so workaday as supply-chain management could have so marked an effect might seem a dull conclusion. But dullness is a virtue, because technological improvement is irreversible. This means the greater stability it provides is likely to be permanent.

The Wall Street shuffle

If better logistics is an unalloyed plus for the economy, the benefits of financial innovation may seem more doubtful—at least just now. Complex derivatives, such as collateralised debt obligations (CDOs), have created a truly nasty mess (see article). But if credit has perhaps been too easy to come by, that was itself a novelty. Credit was strictly rationed until a wave of deregulation and innovation during the 1980s and 1990s led to an expansion. That, in turn, gave a wider range of firms and consumers the means to plug temporary gaps in spending power.

Credit scoring and securitisation have attracted plenty of scrutiny in recent weeks. But the use of techniques to assess the risk of default, together with the repackaging of loans into marketable securities suitable for savers, has broadened access to borrowed funds and broken the rigid link between income and spending. No longer are investment plans tied to the vagaries of a firm's cash flow. And consumers can better match their spending to lifetime incomes. A bigger credit pool means transient declines in earning power need not trigger a downward spiral of falling demand and falling income. These are all valuable advances that smooth out the business cycle.

The third explanation for the moderation is that central banks, in getting to grips with inflation, have fostered more stable economic growth too. Indeed, so widespread is this assumption that the power of central banks is sometimes exaggerated. The rally in the world's stockmarkets over the past month has probably been driven by “faith in the Fed”: the belief that America's central bank will cut interest rates by enough to prevent recession.

In principle, controlling inflation helps steady the economy. High inflation tends to be volatile and research has shown that erratic inflation and large fluctuations in GDP growth tend to go hand in hand. That statistical link might be more than chance. High and variable inflation interferes with the smooth functioning of economies. It obscures the changes in relative prices that tell producers about how customer tastes are always changing. It also leads to variations in real interest rates and volatile patterns in spending.

Though the theory is compelling, empirical studies have struggled to pin down a strong link between better monetary policy and tamer cycles. Ben Bernanke, head of the Federal Reserve, has argued that "the policy explanation for the Great Moderation deserves more credit than it has received in the literature." At the very least, central banks have stopped adding to economic volatility, even if they have not done so much to actively reduce it.

The shock-absorber that shocked

Although it is perverse to argue the golden age has not been tested, it would be foolish to rule out a shock (or combination of shocks) that might break the economy's resilience. Combine the present discord in credit markets with the seeming vulnerability of housing markets and it is all too easy to imagine the rich-world economies in trouble.

What makes today's turmoil so disturbing is that one of the mechanisms which helped stabilise growth has suddenly become a threat to it. Financial innovation is central to the Great Moderation, but its most recent creations allowed credit to be extended on too easy terms. The fallout is now poisoning the markets for short-term funding that are so essential to the economy's smooth functioning.

Because of rising arrears and defaults on American subprime mortgages, investors have lost faith in the securities backed by them. The impact has broadened to a more general revulsion against assets in which the income depends on repayments of consumer debt. As funding dried up, the resulting squeeze has put upward pressure on the money-market interest rates that determine the cost of borrowing for households and small businesses.

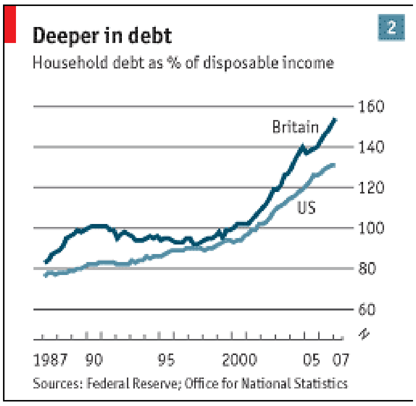
As long as credit markets stay impaired, the economy's normal self-regulation cannot fully be relied upon. A channel that for so long has helped smooth economic growth might now threaten it. A shock-absorber could turn into a shock-amplifier.

Indeed, the very stability of growth may have encouraged people to take on a debt burden that could prove troublesome. Strong credit growth is both cause and consequence of the golden age.

Belief that the business cycle has been tamed for good helps explain why property prices in many rich countries have risen so high and why there has been such a willingness to take on debt at large multiples of income. A less volatile economy makes income streams more reliable and, goes the argument, justifies higher prices for all assets, including housing. A reduced fear of job losses means homebuyers in America, Britain and elsewhere have been content to take out huge home loans.

But like all booms, the housing rush is dependent on ever-more risky borrowers to prop it up. Once credit conditions tighten, the marginal homebuyer is frozen out of the market. That is one likely consequence of the trouble at Northern Rock, a mortgage bank that was rescued this week by the British government (see article). Northern Rock was responsible for a huge share of mortgage lending earlier this year. But after a run on the bank its ability to write new business has vanished.

Britain has been growing steadily in the last year, but it has the same fault lines as America—an overvalued housing market, high consumer debt (see chart 2) and a huge trade deficit. Unlike other European countries, it has a big non-prime mortgage market too. Though less than 10% of recent loan growth has been in subprime, this rises to around 25% if you count borrowers who never had to prove how much they earn, according to David Miles, at Morgan Stanley.



Just as the germ carried from America's subprime mortgage market is now infecting money markets elsewhere, so the housing downturn itself could spread globally. As Alan Greenspan, the former Fed chief, reminded everyone this week, there have been housing booms in at least 40 different countries and "the US is by no means above the median". If global house prices are as correlated on the way down as they were on the way up, the pain will not be confined to America. The cracks that have spread with the credit crisis could be the network through which the housing malaise travels.

As central banks try to mitigate these risks to growth, the danger is that they become complacent about inflation. There is a sorry story of how monetary laxity once undermined hopes for a more stable economy. In 1959 Arthur Burns, then chairman of the National Bureau of Economic Research (NBER), made a famous prediction that "the business cycle is unlikely to be as disturbing or troublesome to our children as it once was to our fathers." For a decade that optimism seemed justified. But in the 1970s, on Burns's watch as Fed chairman, unemployment rose, inflation took off and a growing sense of economic crisis made a mockery of the idea that governments could control the business cycle. Attempts to fine-tune the economy through cheap money instead led to higher inflation and increased economic instability.

In his new book (see article), Mr Greenspan delivers a timely warning that progress in policymaking is always vulnerable to reversal. Looking to 2030, he fears that the burdens of an ageing population will eventually lead to upward pressure on inflation. And future Fed chairmen cannot rely on the deflationary effects of globalisation to tame prices, as Mr Greenspan could, as over time that impulse will fade.

Mr Greenspan questions the political will to enforce price stability. "Whether the Fed will be allowed to apply the hard-earned monetary policy lessons of the past four decades is a critical unknown. But the dysfunctional state of American politics does not give me great confidence in the short run."

Once people sense inflation is slipping out of control, changes in expectations can quickly become self-fulfilling. Firms price higher and employees demand wages to match. If inflation expectations slip anchor, central banks will have to ratchet up real interest rates (or bond markets will do the job for them). Policy might again become the source of economic shocks.

Today the stakes are arguably higher. Highly leveraged economies rely on low nominal interest rates to keep debt-service costs manageable. A spike in bond yields would probably cause huge instability as interest costs ate into available spending. If wiser central bankers have indeed played a big role in the Great Moderation, it is sobering to think how easily the dangers of lax monetary policy might be forgotten.

Revising downwards

The prospect of a co-ordinated global housing slump is a very frightening one. For the moment, it remains a plausible risk. If house prices hold up, the credit-market disruption is still likely to harm growth in 2008. Even if money markets settle down—and there are the first signs of this happening (see article)—the loans that banks have been unable to sell as securities will instead sit on balance sheets, crimping their ability to lend. A more careful approach to credit means businesses and households will find it harder to borrow. That will hurt the world economy.

Banking on the Fed

Private-sector forecasts for developed-world growth are understandably being revised down. Revealingly, the biggest changes have been to expectations about interest rates. The likelihood of rate increases in Europe has been largely written off. And many projections for the Fed funds rate were decisively reduced ahead of the decision this week to cut (see article). In essence, the markets are betting the Fed can save the day. Stockmarkets, at least, do not appear to be priced for a recession—or anything like it.

On this they may be simply following the form book. If central bank actions are credited with mitigating previous downturns, then why not this one? The global economy has proved to be far more resilient than had often seemed likely. And it showed very few signs of trouble before the credit-market dislocations, mostly because growth outside the rich world has been strong.

In July the IMF revised down its projections for economic growth in America for this year, but still upgraded its global economic forecasts because of the strength of the emerging markets. These economies—a source of a big shock only a decade ago—could now prove to be a stabilising force for the world economy. Thanks to their handsomely cushioned foreign-exchange reserves, the fast-growing economies of Asia and the Middle East are now less dependent on capital markets to fuel their growth.

America remains the biggest risk. Even here, where the outlook is gloomiest, recession is not a forgone conclusion. Perhaps the best that can be hoped for—and maybe what policymakers are trying to engineer—is a continuation of the muddle-through growth of the past year or so. That would help contain pressures on inflation without causing excessive dislocation in the economy. But the risks to even this outcome are on the downside.

In the past year, America has become less central to global growth. But it is a big importer and a hard landing would affect other countries. Its fortunes over the next year will still have huge significance for other reasons too. America has been at the leading edge of the Great Moderation and has arguably pushed the boundaries of risk-taking furthest. If America falls hard now, it will be a harbinger for the rest of the rich world.